



ASIAN ROUNDTABLE

TASK FORCE ON

RELATED PARTY TRANSACTIONS

MANILA, PHILIPPINES, 5-6 FEBRUARY 2009

*Renaissance Makati City Hotel Manila
Esperanza Street Corner Makati Avenue
Makati City, 1228 Philippines*

**CONCLUSIONS AND KEY
FINDING NOTE**

Meeting Co-hosted by:



**INSTITUTE OF
CORPORATE
DIRECTORS**

Organised In partnership with:

the Government of Japan

Conclusions and Key Findings Note¹

1. This meeting was hosted by the Philippines Stock Exchange and the Institute of Corporate Directors, with the support of the Japanese government. The discussion was based on the Issues Paper prepared by the OECD Secretariat. The Paper builds on the recommendations concerning related party transactions endorsed in the 2003 *White Paper on Corporate Governance in Asia* (“White Paper”)², background papers on China, India and Indonesia as well as Roundtable discussions in Singapore (2007) and particularly Hong Kong (2008). The Paper refers to two kinds of abusive related party transactions. First, transactions causing a material misstatement of the company’s financial situation, and second are the transactions causing material conflicts of interest for directors.

2. This Task Force was established by the Asian Roundtable at its 2008 Hong Kong meeting in order to develop a ‘Practical guide to monitoring and curbing abusive related party transactions in Asia’, which is one of the biggest corporate governance challenges around the world. These transactions take place when a deal is entered into by a “listed” company and another entity (person or company) where one has control over the other or where the parties come under the same control of another. Under certain conditions, these transactions can allow controlling shareholders to benefit personally at the expense of public investors or minority shareholders. At a time of global financial crisis when risk management, the responsibility of the board and transparency are being questioned, these transactions have risen to the forefront of the global debate.

3. This Note focuses on the debate itself, drawing out key findings. Detailed comments are being incorporated into the Updated Issues Paper for discussion by the OECD Steering Group on Corporate Governance and the power point presentations are available on the OECD website. Below are some highlights from the dynamic Task Force discussion:

- We had an excellent group of active high level experts who were extremely engaged in making sure we covered the key issues. We ended up with a consensus on most of the issues and initial recommendations, with the exception of some ‘thorny’ ones like harmonization of disclosure requirements and definitions, the role of non-controlling owners to nominate independent directors, how to account for informal relationships in the definition of related parties and enforcing fiduciary duties.
- Participants agreed to the proposed roadmap in developing the Practical Guide to Monitoring and Curbing Abusive Related Party Transactions, including the constitution of a small drafting group suggested by the OECD Secretariat. They also agreed to actively pursue consultations in their own countries and to broadly disseminate the results.
- Participants also provided extremely useful input to the draft agenda of the 9-11 September 2009 Asian Roundtable so that we have a more focused and deeper discussion that could lead to

¹ The agenda and issues papers as well as presentations are available on the OECD website: www.oecd.org/daf/corporate/principles

² The White Paper put 6 Priorities for Reform, including Priority 4; Boards of directors must improve their participation in strategic planning, monitoring of internal control systems and independent review of transactions involving managers, controlling shareholders and other insiders, and Priority 5; The legal and regulatory framework should ensure that non-controlling shareholders are protected from exploitation by insiders and controlling shareholders.

consensus among a more diverse group of players. The two main issues will likely be the global financial crisis, corporate governance implications for Asia and implementing the Practical Guide.

Session 1 – Public disclosure – Is sunshine sufficient?

4. The discussion focused on three key issues: ensuring accurate disclosure of related parties and related party transactions, evaluating the costs and benefits of disclosure requirements, improving effectiveness of the board audit committee as well as the external auditor. Participants discussed at some length the challenge of determining the fair value of related party transactions and defining related parties, particularly in financial institutions, and obtaining an independent appraisal. This led to a debate about the effectiveness of external auditors and importance of their accountability, notably the critical role of the audit committee.

5. A key issue is enforcement and here the ability of the regulator to ensure effective oversight is important as well as sanctions for misconduct. The latter may include reputational methods, such as an announcement on a website, by the media or a stock exchange but this may not be enough. Another aspect is how to create incentives for management to provide timely and accurate information and how to ensure that shareholders receive information that is easily understood.

6. Participants also stressed that a rules-based approach has some limitations, i.e. the more detailed the rule the more opportunities there are to find ways around it, and the difficulty of accounting for informal relationships is a case in point. Another issue that came out of the debate is how to ensure smart regulation, to minimise the costs while raising the benefits. A regulatory impact assessment of new regulations may be amongst the solutions. Participants stressed that the quality of disclosure to the public and regulators is also very important and should not be neglected.

Session 2 – Decision Making Process: Responsibility of the Board

7. The discussion focused on how to make the system of independent decision-making work in practice. Participants noted that the concentrated ownership structure in Asia hinders board effectiveness because controlling shareholders often have a strong influence on the nomination and election process of directors. While there is no perfect method for distinguishing sound related party transactions from harmful ones, the decision-making process is critical to curbing potentially abusive related party transactions and protecting the equitable treatment of shareholders.

8. Independent directors have a responsibility to provide objective and informed judgment into the decision-making process of the board. Keeping in mind the specific circumstances in Asia, some participants proposed that the nomination process should also allow non-controlling shareholders to exercise their influence on board composition as well as develop incentive structures for independent directors. While some argue that this may be in conflict with the one-share-one-vote principle, some participants felt that this may be a viable way to create a system of checks and balances on the board.

9. Some participants suggested that cumulative voting should receive more attention in Asia as it may be a possible solution given the context of concentrated ownership. However, it was noted that implementation in some jurisdictions, such as Korea has not been effective as the law allows firms to opt out. Participants also discussed remuneration of directors, stressing that the issue is not whether the level of compensation is too high or too low but what is the incentive structure, keeping in mind the need to - increase incentives to monitor management while avoiding having directors become entrenched and lose their independence. It is important to ensure that compensation is linked to long-term performance but at the same time that unethical behaviour or failure to perform is penalised.

10. Participants noted the importance of directors demonstrating the highest level of professionalism. Training is essential not only to inform directors about their roles and responsibilities, but also to educate them about related party transactions. Perhaps an annual evaluation of board performance could be considered. The regulator should also have some authority to call on the board to explain any violations. Some economies impose sanctions on directors who fail to report vital information. However, there is a need to balance incentives and sanctions.

Session 3 – Decision-making process: Role of the Shareholders Meeting

11. Case studies of what actually happens during shareholder meetings were presented. In particular, the Satyam case in India offers some lessons concerning approval procedures of company transactions and disclosure of the valuation process. The case of the SK Corporation in Korea demonstrates problems with cross-guarantees and a questionable voting process. Also, a case in Singapore of the real estate investment trust (REIT) demonstrates challenges when the monitoring system of the board is not working.

12. Participants stressed that participation in shareholders meetings and education of shareholders are still critical issues. Whether an appropriate notice period is ensured or not is another key point. Participants praised China for having introduced regulation to allow electronic voting for shareholders meetings in order to lower the cost of the voting.

13. In some Asian jurisdictions, disinterested shareholders are required to approve material related party transactions. A question issue, however, is if shareholders have sufficient and appropriate information to make an informed decision and if they are able to consult with management for clarification. A question was raised on whether individual opinions by directors are required or not. There is no jurisdiction in Asia with such an obligation. In Hong Kong, independent directors, with the support of an opinion from the independent financial adviser, are required to advise shareholders as to whether the terms of the relevant transaction are fair and reasonable.

14. Also, participants stressed that the role of institutional investors is very important for enhancing the effective functioning of the shareholders meeting. Facilitating a proxy voting system would facilitate their activities and to exercise their voting. The meeting also discussed whether the vote of shareholders should be taken by poll.

Sessions 4 – Fiduciary duties: A precondition for enforcement

15. The discussion began with a presentation of the Chinese experience. In China, directors are required to exercise their fiduciary duties. Administrative sanctions for the breach of fiduciary duties include fines, confiscating illegal income, disqualification of directorship, order to end the breach, order to correct the violation, and banning directors from serving on boards of listed companies, securities companies, fund management companies and other related institutions. The threat would not be credible if the fine is insignificant. Investors can file a law suit against directors or supervisors who could face criminal charges. The criminal penalty includes imprisonment and criminal detention. However, it is very rare that directors get a criminal conviction. The civil law suit is not functioning properly unless the Chinese Securities Regulatory Commission has sanctioned the company and its directors in advance because the civil court rarely accepts cases related to the securities market. As an alternative to investor protection, Shanghai is establishing a financial court system specializing in securities law. There is currently some debate about whether China should lower administrative control and introduce class action as well as develop civil liability for directors.

16. Participants stressed the importance of regulatory action in promoting fiduciary duties of directors and the sharing of experience among economies in Asia. Director training in China is organized by stock

exchanges and regulators; however there is no institute of directors. In Thailand, director training is mandatory and there is an orientation programme for new directors organized by companies. There is a general concern that directors do not fully understand the meaning of fiduciary duties in practice, due in part to a lack of consensus on its meaning. Different people may have different interpretations of what is considered to be “in the interest of the company”.

17. It was pointed out that with respect to law suits against directors for misconduct, there could be a free-rider problem with other shareholders benefiting at the expense of those who brought the law suit. It was suggested that this could be resolved by assigning a premium to the shareholder who launched the law suit. Some participants recommended that the regulator should take the lead in suing directors for misconduct. However, a major challenge is the ineffectiveness of the legal system in many Asian economies. An on-going communication channel between judges, lawyers and the securities market regulator could provide a more conducive environment to learn from each other to improve the system.

18. It was noted that in Belgium, companies have to set up a special committee composed of three independent directors to examine the intra-group transactions using also the independent auditor’s report. In Asia, in the case of intra-group transactions, frequently a director will act in the interest of the group rather than the company.

Session 5 – Enhancing enforcement and implementation

19. A participant from Malaysia introduced their efforts to enhance enforcement and implementation. It was noted that in Malaysia, it is the Companies Commission rather than the Securities Commission that acts as a statutory body regulating companies under the Companies Act. The Act prohibits some related party transactions such as loans to directors. If there is a violation of the related party transaction provisions in the Companies Act, it is the director rather than the company who is sanctioned.

20. Some participants stressed that administrative sanctions by regulators are not enough and that the Asian corporate governance landscape relies too heavily on courts as a last resort as well as media criticism. The Hong Kong experience suggested that further coordination among authorities is required to maximise the use of limited resources. Also, the role of institutional investors is very important.

21. The harmonization of the regulatory framework in each jurisdiction was a big debate in this session. Some participants stated the difficulty with harmonization, while others were concerned about adding an additional layer of regulation. Participants discussed the experience in Europe, notably, that basic concepts are being harmonized (e.g. financial reporting) while the details of regulation are specific to the circumstances in each jurisdiction. As harmonization of some regulations may be a long-term goal, it was suggested that Asia could focus in the short term on developing mutual recognition, in particular to enhance regulatory capacity and consensus building of rules on related party transactions.

Session 6 – Proposed policy recommendations for the “Practical Guide to Monitoring RPTs”

22. Participants commended the preparatory efforts for this meeting and in particular, the Issues Paper which stimulated the discussion. With regard to harmonizing the definition of related party transactions in Asia that is spread across the company law, listing rules, accounting standards etc., it was suggested that the Practical Guide include the phrase “...to the extent possible” given the inherent difficulties in the process. Participants noted the need to take into account the enabling laws in different jurisdictions, the cost-benefit considerations as well the ability to enforce by regulators. The risk not to harmonize approaches to related party transactions is that issuers will play the game of regulatory arbitrage, and the race to the bottom will see issuers potentially choosing the least onerous location to list, with cost as a major factor.

23. It was suggested that the Asian Roundtable seriously consider whether related party transactions are subject to company law (statutory) or listing rules (no statutory backing). Awarding non-interested shareholders a vote on the election of independent directors is a big and difficult challenge, threatening the fundamental design of corporate governance, the one-share one vote principle. The nomination committee in a closely held corporation can be an alternative solution. The role of auditors has also been commented on. Indeed, auditors play a key role in protecting shareholders. But we should remember that, untimely, these are a group of professionals indirectly employed by the company. The participants expressed support for the exposure draft comment on the role of external auditors in the related party transaction process, and that auditors should provide high levels of accountability as whistle-blowers, and for the rotation of audit partners.

24. It was pointed out that companies will always try to find loopholes around the rules, particularly in the context of intra-company financial assistance. Participants also discussed the importance of minority shareholder groups, particularly since individual shareholders may not all be sufficiently sophisticated to deal with these issues. However, it was recognized that shareholder activism is resource intensive.

25. Participants stressed that the wording of some of the exposure draft was somehow 'strong' in places around the disenfranchising of certain shareholders from voting. It was mentioned that cumulative voting was common in Latin America, yet had not solved the problems of minority shareholder protection. It was stressed that cumulative voting doesn't work if minority shareholders are not organized. Participants agreed that cumulative voting provides an opportunity but does not automatically solve the problem. The proposed Practical Guide should also include views on voting procedures, addressing issues like the bundling of related party transaction items, voting by poll vs. show of hands, but the question is what level of detail should be covered. There was no clear agreement, but participants mentioned the importance of discussions on the disclosure of votes.

26. Participants agreed that the role of the external auditors is as important as the role of independent directors, and that the Practical Guide should stress this. Some participants suggested that there be lists of accredited public auditors kept in each market, to lend legitimacy to auditors and to maintain quality, while other participants also suggested that auditors need to be well regulated, and should follow relevant promulgations of the International Federation of Accountants (IFAC), including International Standards on Auditing and IFAC Code of Ethics for Professional Accountants.

27. It was also noted that external auditors play an important role in checking related party transactions as part of the audit process – ensuring that the related party transactions that occurred were in line with the approval procedures as agreed by shareholders. This is the case in Hong Kong, where auditors provide a confirmation on recurring related party transactions for disclosure in the annual report.

Concluding Session

28. Participants agreed to the following steps as well as to forming a Small Drafting Group:
- Updating the Issues Paper based on the discussion in Task Force meeting (mid-March)
 - Collecting comments on the updated paper from Small Drafting Group (early April)
 - Preparation of the Practical Guide (April to June)
 - Collecting comments from the drafting group (early June)
 - Finalising the Practical Guide (end June)

29. The OECD Secretariat introduced the draft agenda for the next Asian Roundtable to be hosted by the Philippines on 9-11 September 2009. Participants suggested that the agenda focus on fewer items. There was considerable interest in a focus on lessons to be learned from the global financial crisis as well

as future work, possibly to revise the Asian White Paper. Participants were pleased with previous experience in having break-out sessions and found this extremely useful, to bring different institutions together to discuss a specific aspect of a problem, in-depth. Most participants also stressed that the Roundtable meeting should help build consensus on policy reforms.